Industry Note

Equity Strategy

Revisiting Plutonomy: The Rich Getting Richer

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SUMMARY

- The latest Survey of Consumer Finances, for 2004, has been released by the Federal Reserve. It shows the rich continue to account for a disproportionately large share of income and wealth in the US economy: the richest 10% of Americans account for 43% of income, and 57% of net worth. The net worth to income ratio for the richest 10% of Americans increased from 7.4x in 2001, to 8.4x in the 2004 survey. The rich are in great shape, financially.
- We think this income and wealth inequality (plutonomy) helps explain many of the conundrums that vex equity investors, such as why high oil prices haven't seriously dented growth, or why "global imbalances" are growing along with the equity bull market. Implication 1: Worry less about these conundrums.
- We think the rich are likely to get even wealthier in the coming years. Implication 2: we like companies that sell to or service the rich - luxury goods, private banks etc. Favored names include LVMH and Richemont.

Global

PLUTONOMY: TAKE ANOTHER LOOK

The latest Survey of Consumer Finance data was released Friday 24th of February. It shows that the rich in the US continue to be in great shape. We thought this was good time to bang the drum on plutonomy.

Back in October, we coined the term 'Plutonomy' (The Global Investigator, *Plutonomy: Buying Luxury, Explaining Global Imbalances,* October 14 2005). Our thesis is that the rich are the dominant drivers of demand in many economies around the world (the US, UK, Canada and Australia). These economies have seen the rich take an increasing share of income and wealth over the last 20 years, to the extent that the rich now dominate income, wealth and spending in these countries. Asset booms, a rising profit share and favorable treatment by market-friendly governments have allowed the rich to prosper and become a greater share of the economy in the plutonomy countries. Also, new media dissemination technologies like internet downloading, cable and satellite TV, have disproportionately increased the audiences, and hence gains to "superstars" – think golf, soccer, and baseball players, music/TV and movie icons, fashion models, designers, celebrity chefs etc. These "content" providers, the tech whizzes who own the pipes and distribution, the lawyers and bankers who intermediate globalization and productivity, the CEOs who lead the charge in converting globalization and technology to increase the profit share of the economy at the expense of labor, all contribute to plutonomy. Indeed, David Gordon and Ian Dew-Becker of the NBER demonstrate that the top 10%, particularly the top 1% of the US – the plutonomists in our parlance – have benefited disproportionately from the recent productivity surge in the US. (See "*Where did the Productivity Growth Go? Inflation Dynamics and the Distribution of Income*", NBER Working Paper 11842, December 2005). By contrast, in other countries such as Japan, France and the Netherlands (read much of continental Europe), egalitarianism has kept the rich to a similar share of income and wealth

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that they accounted for in the 1980s – in other words, they haven't really gotten any richer, in relative terms.

We believe that the plutonomy thesis helps explain some of the conundrums that vex so many equity investors, such as why high oil prices haven't slowed the global economy, why consumer confidence might be low yet consumption remains robust in the US, why savings rates are low, and why the dollar depreciation hasn't done much for the US trade deficit.

Why as equity investors do we care about these issues? Despite being in great shape, we think that global capitalists are going to be getting an even greater share of the wealth pie over the next few years, as capitalists benefit disproportionately from globalization and the productivity boom, at the relative expense of labor. As we believe plutonomy explains away some of the conundrums we highlighted above, we are very relaxed about these issues.

Indeed, if the rich keep getting richer, as we suggest, savings rates might get even worse in the plutonomy countries. If plutonomy explains away many conundrums that our equity clients worry about, then this suggests the risk premia ascribed to equities might be too high.

Furthermore, if the rich will be getting even richer in the coming years, this bodes extremely well for businesses selling to or servicing the rich, be it for example luxury goods stocks or private banks. The rich are a growing and captive market, who have the nice habit of relatively little price elasticity. The plutonomy basket of luxury goods stocks, private banks etc. has handsomely outperformed the S&P500 index since 1986, and we expect similar outperformance from these types of stocks in the years to come. In the last 3 months alone, these stocks have outperformed the MSCI AC World index by 7%.

For these reasons, the recently released US Survey of Consumer Finances, which confirms that the rich continue to get wealthier and account for a disproportionate share of income and wealth in the US, is important. It confirms that the dynamics of plutonomy are still intact.

SURVEY OF CONSUMER FINANCES

The Federal Reserve recently released their triennial Survey of Consumer Finances (SCF), conducted in 2004, which looks at the state of household finances in aggregate and by various sub-categories. The data shows that the gap in incomes and wealth between the rich and the poor in the US shows no signs of significant change, and that the richest 10 and 20% of Americans continue to earn disproportionately high chunks of national income, and own an even higher share of the national wealth.

Figures 1 and 2 show the income and wealth shares of the top two deciles, the next two quintiles and the remaining 40% of US households. We have lumped the bottom 40% into one to emphasize how relatively small their income and wealth shares are.

Figure 1. U.S. Plutonomy Remained Intact in 2004: Based on the Consumer Finance Survey, the Top 10% of the Families Accounted For 43% of Income, while the bottom 40% of Families Accounted For Only 10% of Income

Survey	1995	1998	2001	2004
Percentile of income	**Mean Income** in thousands of 2004 dollars			
Top 10%	215.8	254.5	322.4	302.1
Next 10%	85.7	92.2	104.4	106.5
Next 20%	57.0	63.0	69.4	69.1
Next 20%	37.1	39.4	42.9	43.4
Bottom 40%	14.9	16.3	18.2	18.5
		Share		
Top 10%	39%	41%	45%	**43%**
Next 10%	16%	15%	14%	15%
Next 20%	21%	20%	19%	20%
Next 20%	14%	13%	12%	12%
Bottom 40%	11%	11%	10%	**10%**

Source: Survey of Consumer Finances, Federal Reserve Board, and Citigroup Investment Research

Figure 2. Little Change in the Net Worth Share in 2004: The Top 10% of Income Groups Account for 57% of Households' total Net Worth While the Bottom 40% Has 9% of Net Worth

	1995	1998	2001	2004
Percentile of income	**Mean Net Worth** in thousands of 2004 dollars			
Top 10%	1,338.0	1,793.9	2,406.7	2,534.4
Next 10%	316.8	377.1	486.6	485.0
Next 20%	198.5	238.3	311.3	342.8
Next 20%	126.0	146.6	171.4	193.8
Bottom 40%	76.1	83.5	89.0	97.3
		Share		
Top 10%	51%	55%	57%	**57%**
Next 10%	12%	12%	12%	11%
Next 20%	15%	15%	15%	15%
Next 20%	10%	9%	8%	9%
Bottom 40%	12%	10%	8%	**9%**

Source: Survey of Consumer Finances, Federal Reserve Board, and Citigroup Investment Research

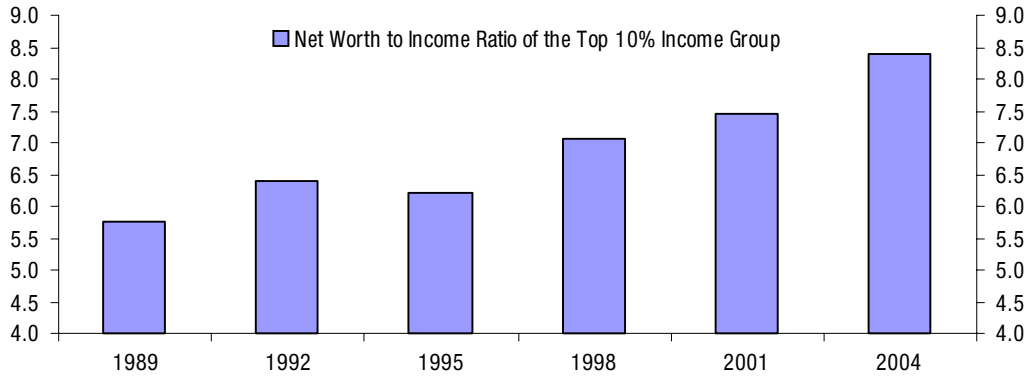
The top 10%, whose mean annual income level was U$302,000 in 2004 have lost out a little in terms of their share of income, with this falling from a peak of 45% of national income in 2001 to "just" 43% of total US income, in 2004. Meanwhile, the fortunes of the next 10% improved modestly, to 15% of total income. The top 20% account in aggregate for 58% of total income (down from 59% in 2001). By contrast, the bottom 40% account for only 10% of total income. The top 10% earn over four times as much as the bottom 40% combined.

The share of the wealth continues to be even more aggressively skewed, with the top 10% accounting for 57% of the national wealth, as they did in 2001. In total, the top 20% account for 68% of total income; the bottom 40%, for just 9%.

The overall point here is that the rich continue to be in great shape, in relative terms. Indeed, their net wealth to income ratio (Figure 3) has risen since the 2001 survey was published. It now stands at 8.4, in other words, net wealth is over eight times annual income. In 1995 this ratio was a relatively meager 6.2. We think this rising wealth is the real reason why the rich are happy to keep consuming, and are behaving rationally in so doing. They simply do not

need to save as much to maintain a healthy wealth balance, as they did in prior decades, because their wealth is growing rapidly.

Figure 3. U.S.: Net Worth to Income Ratio for the Top 10% Is High and Rising. Drives and Sustains High Consumption out of Their Wealth and Income; Keeping Aggregate Savings Rate Low and Current Account Deficit Large



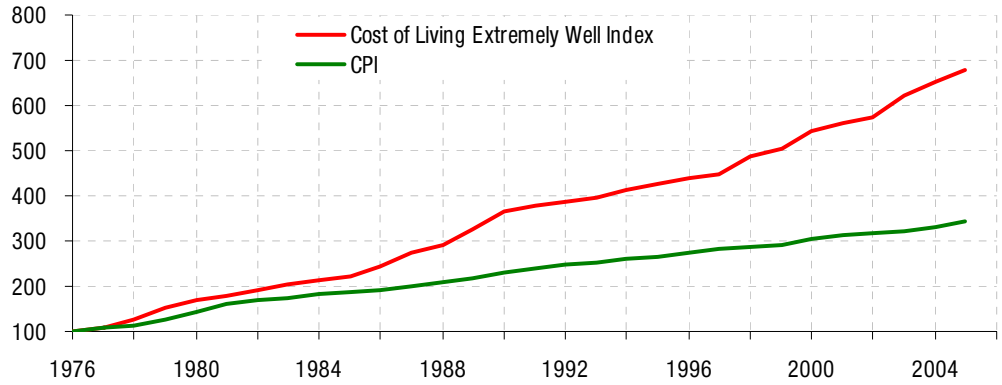
Source: Survey of Consumer Finances, Federal Reserve Board, and Citigroup Investment Research

IT'S NEVER BEEN MORE EXPENSIVE TO BE RICH....

Another new data point we have is the CLEW (Cost of Living Extremely Well) Index from Forbes Magazine for 2005 (in our original Plutonomy note back in October, we didn't have the latest data point for the year 2005).

CLEWI is an inflation index of the cost of luxury goods. It measures such things as the cost of suite at the Four Seasons in New York (up 15% year on year) and a kilo of Imperial Beluga caviar (at US$6840, up 40% year on year). In 2005, the CLEW Index rose 4%, while US CPI rose at 3.6%. Luxury goods still have relative pricing power. The 0.4% gap might not sound all that impressive, but bear in mind that a stronger US dollar, probably helped check this inflation rate (many luxury goods come from Europe, but the CLEWI is a measure in dollars). At any rate, the year to year fortunes of the CLEWI versus the CPI are less relevant. The long-term chart says it all (Figure 4). The most recent data point just confirms that in the search for pricing power, we'd rather be in luxury goods, than low end consumer businesses.

Figure 4. Forbes "The Cost of Living Extremely Well Index" – Pricing Power for Luxury Goods Much Stronger than Overall CPI Over Time



Source: Citigroup Investment Research, and Forbes

THE 4 CONUNDRUMS

This is a good time, with the release of the latest SCF data, to reiterate our plutonomy thesis, and how when viewed through the prism of plutonomy, many of the apparent conundrums in the world seem less tricky to digest.

➤ 1) Oil and the Consumer.

We have heard constantly that oil will slow consumption down as it eats into disposable income. But it remains a conundrum to many that consumption has remained robust, despite oil prices remaining high. What's going on? We don't see a conundrum. As we wrote about in September (The Global Investigator, *Is Oil Relevant for Equities,* September 2 2005), in the plutonomy countries, the rich are such a massive part of the economy, that their relative insensitivity to rising oil prices makes US$60 oil something of an irrelevance. For the poorest in society, high gas and petrol prices are a problem. But while they are many in number, they are few in spending power, and their economic influence is just not important enough to offset the economic confidence, well-being and spending of the rich.

➤ 2) Consumer Confidence and Consumer Spending

A second related conundrum, and one that ex Fed Vice–Chairman Roger Ferguson spoke of as long ago as 2001, is why consumer confidence and spending have not moved in sync with prior patterns. As Mr. Ferguson put it "A somewhat puzzling feature of the recent period has been that, despite the sharp weakening in sentiment, household spending appears thus far to have held up well. How these apparently conflicting signals will be resolved going forward is not at all apparent from today's vantage point, and will bear close scrutiny." Remarks to the University of North Carolina School of Law, Feb 27 2001**.** This thesis came up again last year in relation to Hurricane Katrina, when consumer confidence fell sharply, yet consumption (ex autos) was just fine.

Again, we see this as being a lot easier to understand if viewed through the prism of plutonomy. While the average consumer might not be feeling great, the important consumers – the richest 20%, who account, as we've shown, for 58% of income – are in good shape. Rather than focus on consumer sentiment indicators like the Conference Board sentiment index, we highlight our own February Citigroup Smith Barney/CNBC Affluent Investor Poll. Affluent investors appear quite optimistic about the future prospects. Indeed the more affluent they are, the more upbeat they are about future prospects. "*Projections for the next year are positive among all investors. About two in five believe they will be better off financially in the coming year and 39% foresee things being no worse. An even brighter*

outlook for their financial status over the next 12 months is evident among the wealthiest group of investors (assets of $1 million or more), with 46% saying they will be better off financially in the coming year", (see Appendix 1 for the background and methodology of the survey which was first released in January 2006).

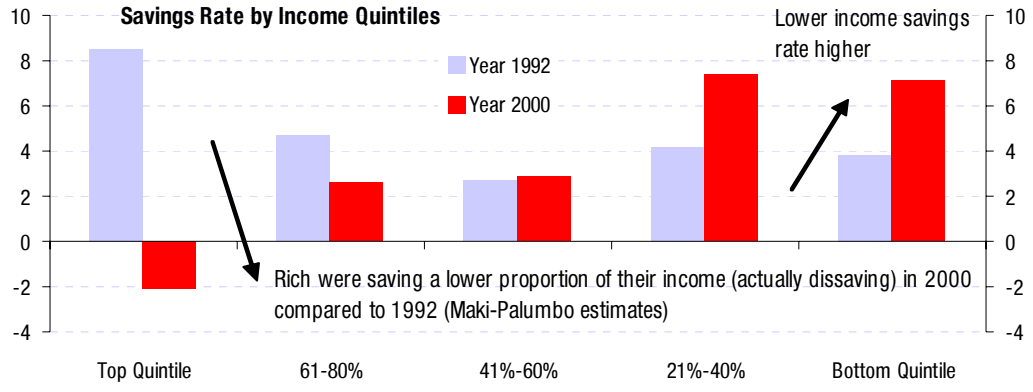
The point here, again, is that the rich are feeling a great deal happier about their prospects, than the "average" American. And as the rich are accounting for an ever larger share of wealth and spending, it is their actions that are dictating economic demand, not the actions of the "average" American.

➤ 3) Low Savings Rates

The "disaster waiting to happen scenario" we hear about most from our clients, is the low savings rates in countries such as the UK and US. Well, we disagree that this is such a big problem in the near term, the time horizon that matters for most equity investors. As we showed in our note on Plutonomy back in October, using data from a paper written by two (then) Fed economists, the low savings rate in the US (and we believe the same holds true in the other plutonomy countries like the UK, Canada and Australia) is a function of the savings habits of the richest 20%. Figure 5 shows the savings rates split down by income quintile in the US. The richest quintile are primarily to blame for the overall fall in the savings rate in recent years – although there low savings behavior has likely been joined in the past few years by the housing-pumped non-plutonomist US consumer.

The rich are being perfectly rational. As their wealth/income ratios have been rising, and as we highlighted earlier, the latest SCF data suggests wealth/income has grown even larger, why should they not consume from their wealth rather than just their income? The more rich people there are in an economy, and the more affluent they feel (as they do right now), the more likely we believe an economy will be to experience falling savings rates. When your wealth has soared, the need to save diminishes. Rational, but apparently a conundrum and an accident waiting to happen, according to the perma-bears. Not to us.

Figure 5. Household Savings Rates of the Rich Fell in the Stock Boom in the 1990s While Those of the Lower Income Groups Rose (Maki-Palumbo Estimates for 1992 and 2000)



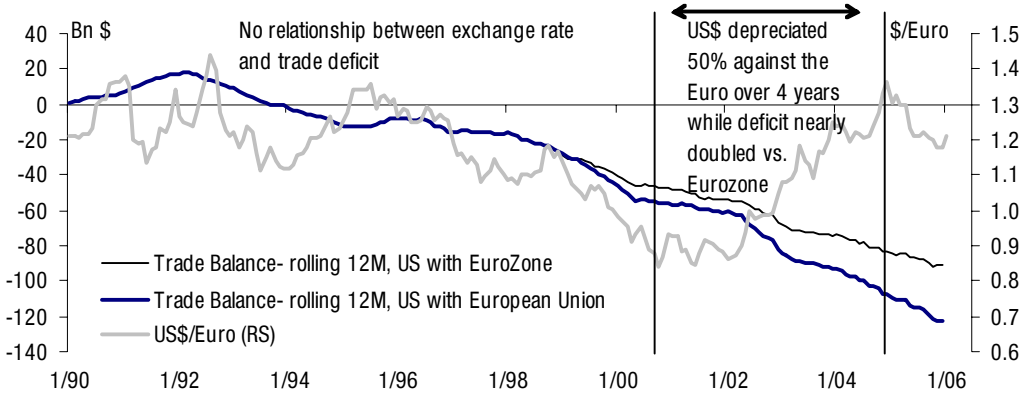
Source: Maki, Dean M. & Palumbo, Michael G. "Disentangling the Wealth Effect: A Cohort Analysis of Household Saving in the 1990's". Board of Governors of the Federal Reserve System & Putnam Investments. April 2001.

➤ 4) Global Imbalances and the US Dollar

Finally, the dollar. The perma-bears told us that the current account deficit in the US was too high. It could only be lowered by raising the savings rate of the household sector which in turn would only be accomplished by rising interest rates and/or a dollar collapse. We disagree. To us plutonomists, the current account deficit is largely a function of the savings

rate, which is a function of the propensity to save by the rich. As we highlighted above, they are rationally consuming out of their stock of wealth (which incidentally, keeps going up) as well as from their incomes. To them, dollar devaluations are a mild inconvenience, but not a reason to change their spending and dis-savings habits. Here's the real conundrum: if a dollar collapse is the primary way to adjust global imbalances, we would have expected the bilateral trade deficit between the US and Eurozone to have moderated following the dollar's more than 50% devaluation against the Euro between Nov 2000 and Nov 2004. Did that happen? No. The bilateral trade deficit (on a rolling 12 month total basis) *nearly doubled* from $47.5 billion to $83.6 billion. The bottom line to us is that plutonomics is a better explanation of these 'nasty' deficits, and currency manipulation just doesn't change the habits of plutonomists enough to make a difference.

Figure 6. Example of A Conundrum We Believe Plutonomy Sheds Light on: Euro/US$ Exchange Rate Appears Unrelated to the Increasing U.S. Trade Deficit with Europe



Source: CEIC and Citigroup Investment Research

PLUTONOMY AND THE EQUITY MARKETS

There are, in our opinion, two issues for equity investors to consider. Firstly, if we are right, that plutonomy is to blame for many of the apparent conundrums that exist around the world, such as negative savings, current account deficits, no consumer recession despite high oil prices or weak consumer sentiment, then so long as the rich continue to get richer, the likelihood of these conundrums resolving themselves through traditionally disruptive means (currency collapses, consumer recessions etc) looks low. The first consequence for equity investors who worry about these issues, is that the risk premia they ascribe to equities to reflect these conundrums/worries, may be too high.

Secondly, if the rich are to keep getting richer, as we think they will do, then this has on-going positive implications for the businesses selling to the rich. We have called these businesses "Plutonomy stocks". We see three reasons to take another look at those plutonomy stocks.

1) The Survey of Consumer Finances continues to show the robust health of the richest consumers in society. The rising net wealth to incomes ratio (now standing at over 8.4x) is an indication of just how robust the balance sheets of the rich are. While we have concerns about the spending power of the middle-income consumer in the US in the event of a housing slowdown, the richest 10% are less exposed to a housing slowdown, as their wealth is more diversified. They are rich, feeling good about their wealth (as our Citigroup Smith Barney Affluent Investor poll points out) and likely to spend.

2) While not as impressive as in some previous years, nevertheless the Forbes CLEW Index once again shows what pricing power really is. Once more, inflation in luxury goods rose faster than general CPI as we highlighted earlier. The CLEW Index has doubled relative to overall CPI over the last 29 years. Not only is demand for luxury goods likely to be strong in the near future, but pricing power is good too. A rosy combination.

3) Emerging markets. It doesn't take a genius to have spotted that emerging markets are doing well. The recycling of commodity price liquidity is not only benefiting the emerging markets themselves, but is creating a new breed of brash, confident millionaire consumers. This is a boon to the Plutonomy stocks. Short of buying UK football clubs to play the recycling of these cash flows, we can see a much easier way of playing this strong demand theme in buying the plutonomy stocks.

So what are these plutonomy stocks? Figure 7 shows the names that we used to create our Plutonomy basket back in October. This is not an exhaustive list.

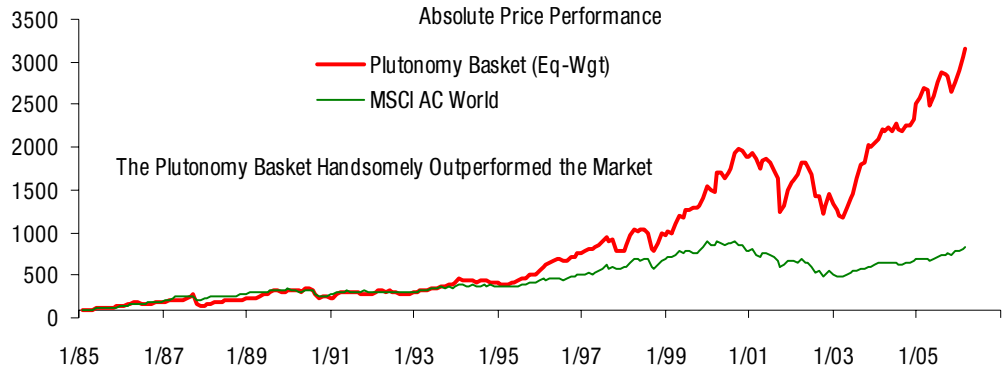
Figure 7. Basket of Plutonomy Stocks

	Company	RIC	Rating	MSCI GICS	Mcap (U$m)	Price (Mar 2)
1	Beneteau	BEN.PA	NR	Cons Durables/ Apparel	1,371	EUR65.65
2	Bulgari	BULG.MI	NR	Cons Durables/ Apparel	3,629	EUR10.16
3	Burberry	BRBY.L	1M	Cons Durables/ Apparel	3,644	£4.6025
4	Coach	COH	NR	Cons Durables/ Apparel	13,893	$36.24
5	Dickson Concepts	0113.HK	NR	Retailing	446	$11.15
6	Four Seasons Hotels	FSH-SV.TO	NR	Consumer Services	1,859	$63.97
7	Hermes	RMS.PA	NR	Cons Durables/ Apparel	9,252	EUR213
8	Julius Baer	BAER.VX	1H	Div Financials	8,387	SwF118.3
9	Kuoni	KUNN.S	1M	Consumer Services	1,286	SwF560
10	LVMH	MC.PA	1M	Cons Durables/ Apparel	46,586	EUR79.35
11	Mandarin Oriental	MOIL.SI	NR	Consumer Services	993	$1
12	Polo Ralph Lauren	RL	NR	Cons Durables/ Apparel	3,629	$58.87
13	Porsche	PSHG_p.DE	3H	Automobiles	7,238	EUR690.34
14	Richemont	CFR.VX	1M	Cons Durables/ Apparel	26,059	SwF59.3
15	Rodriguez Group	ROD.PA	NR	Cons Durables/ Apparel	749	EUR50
16	Shangri-La Asia	0069.HK	NR	Consumer Services	4,072	$12.5
17	Shinwa Art Auction	2437	NR	Consumer Services	204	¥1240000
18	Sothebys	BID	NR	Consumer Services	1,213	$21.1
19	Tasaki Shinju	7968	NR	Cons Durables/ Apparel	212	¥651
20	Tiffanys	TIF	NR	Retailing	5,245	$36.87
21	Tod's	TOD.MI	NR	Cons Durables/ Apparel	2,200	EUR60.7
22	Toll Brothers	TOL	1H	Cons Durables/ Apparel	5,200	$33.52
23	Vontobel	VONN.SW	NR	Div Financials	2,559	SwF51.45
24	Wolford	WOF.F	NR	Cons Durables/ Apparel	127	EUR21.26

Source: Factset and Citigroup Investment Research

These stocks have done very well over the last 20 years. Figure 8 shows the performance of the Plutonomy basket relative to the MSCI AC World Index since 1985. The cumulative annual growth rate of the basket is a cool 17.8%, handsomely outperforming the MSCI World Index.

Figure 8. The Plutonomy Basket Has Handsomely Outperformed the Global Equity Market Since 1985, on Average by 7.3% a Year

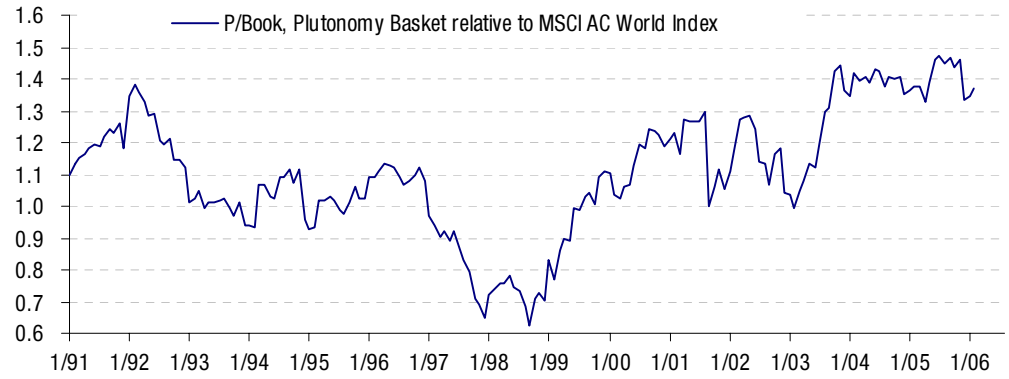


Companies in the Plutonomy Basket:shown in figure 7.

Source: Citigroup Investment Research

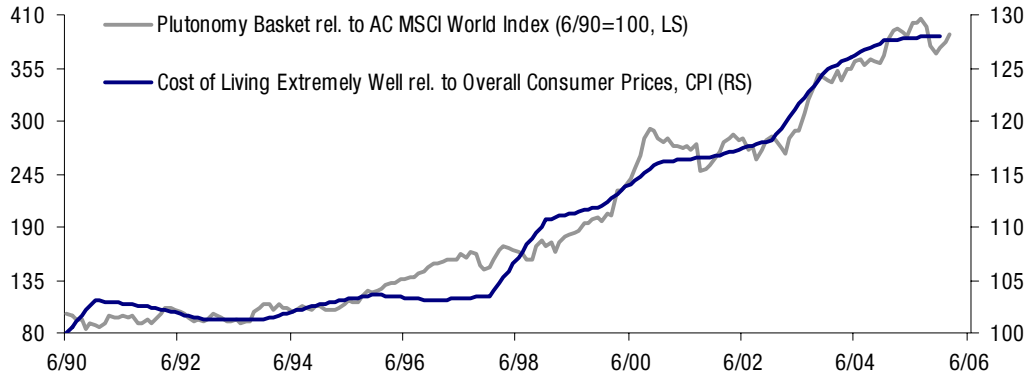
Critics will rightly argue, that the Plutonomy stocks are not cheap. We agree – they are currently close to a 15 year P/Book multiple relative high (1.4), compared to the MSCI World Index (figure 9). However, we find there is very limited predictive power in this valuation metric as a sell signal. A better metric for outperformance is relative pricing power – as figure 10 shows, the plutonomy stocks have tended to outperform when they exhibit relative pricing power, as we think they do right now.

Figure 9. The Plutonomy Basket's P/Book Looks Expensive Relative to MSCI World Index But This Has Little Predictive Power For Future Performance



Source: Citigroup Investment Research, Worldscope and MSCI

Figure 10. The Performance of the Plutonomy Basket Relative to the MSCI World Index Moves In Line with The Pricing Power of the Plutonomy Companies



Source: Citigroup Investment Research, Forbes and MSCI

If we are right, that the rich are going to keep getting richer over the coming years, then this outperformance should, in our opinion, continue. In the short term, we also think them attractive. Of these stocks, we would highlight two in particular – Richemont and LVMH are in our model portfolio.

LVMH recently announced their 2005 results, which indicated robust demand. The company also reiterated their positive outlook for 2006. In the words of our analyst Constanza Mardones, there is "no sign of a slowdown in any of (LVMH's) major markets". Constanza thinks the outlook for earnings looks "highly favorable" with a plausible chance of upgrades to come. The stock trades on 21x Constanza's forecast 2006 eps, and 11.5x 2006E EV/EBITDA.

Richemont recently announced 3Q results, with comparable sales up 14%. Underlying US revenues were up 18% (plutonomy at work). Our analyst Bruce Hubbard is bullish on the Richemont story as operational leverage is leading to margin improvements. Indeed, stronger margins have caused Bruce to upgrade EBIT by almost 25% over the course of the last 12 months. Though in Bruce's own words, the valuation argument no longer looks compelling, he believes that upgrades to forecasts will continue to give upside to the shares. The stock trades on a P/E of 18.6x Bruce's 2006 estimated earnings.

RISKS – WHAT COULD GO WRONG?

Our whole plutonomy thesis is based on the idea that the rich will keep getting richer. This thesis is not without its risks. For example, a policy error leading to asset deflation, would likely damage plutonomy. Furthermore, the rising wealth gap between the rich and poor will probably at some point lead to a political backlash. Whilst the rich are getting a greater share of the wealth, and the poor a lesser share, political enfrachisement remains as was – one person, one vote (in the plutonomies). At some point it is likely that labor will fight back against the rising profit share of the rich and there will be a political backlash against the rising wealth of the rich. This could be felt through higher taxation (on the rich or indirectly though higher corporate taxes/regulation) or through trying to protect indigenous laborers, in a push-back on globalization – either anti-immigration, or protectionism. We don't see this happening yet, though there are signs of rising political tensions. However we are keeping a close eye on developments.

CONCLUSION

The latest Survey of Consumer Finances for 2004 from the Fed, just released, shows that the richest 20% of Americans have gotten even wealthier since the last survey was conducted in

2001, and continue to enjoy a disproportionately large share of both income (58%) and wealth (68%). We should make clear that we have no normative view on whether plutonomies are good or bad. Our analysis is based on the facts, not what the society should look like.

This lies at the heart of our plutonomy thesis: that the rich are the dominant source of income, wealth and demand in plutonomy countries such as the UK, US, Canada and Australia, countries that have an economically liberal approach to wealth creation. We believe that the actions of the rich and the proportion of rich people in an economy helps explain many of the nasty conundrums and fears that have vexed our equity clients recently, such as global imbalances or why high oil prices haven't destroyed consumer demand. Plutonomy, we think explains these problems away, and tells us not to worry about them. If we shouldn't worry, the risk premia on equity markets may be too high.

Secondly, we believe that the rich are going to keep getting richer in coming years, as capitalists (the rich) get an even bigger share of GDP as a result, principally, of globalization. We expect the global pool of labor in developing economies to keep wage inflation in check, and profit margins rising – good for the wealth of capitalists, relatively bad for developed market unskilled/outsource-able labor. This bodes well for companies selling to or servicing the rich. We expect our Plutonomy basket of stocks – which has performed well relative to the S&P 500 index over the last 20 years – to continue performing well in future. From this basket, we would highlight in particular, at the moment, LVMH and Richemont.

Appendix 1. Background and Methodology of the U.S. Citigroup Smith Barney February 2006 Affluent Investor Poll

Greenwald & Associates and Synovate conducted the Citigroup Smith Barney Affluent Investor Poll, done in partnership with CNBC, between January 5 to January 20. Interviewing was conducted online with 561 investors who are members of the Synovate Consumer Opinion Panel. In order to qualify for participation, panel members had to have at least $100,000 in financial assets (excluding real estate and employer retirement plans), a definition that describes approximately one-quarter of all U.S. households. Survey results include 177 interviews with households that have $100,000 to $499,999 in savings and investments, 156 interviews with those in the $500,000 to $999,999 asset range, and 228 interviews with investors who have $1 million or more. Survey results have been weighted by age and asset level to reflect national population norms. The results of the Citigroup Smith Barney Investor Poll have a maximum margin of sampling error (at the 95% confidence level) of plus or minus four percentage points.

VALUATION AND RISKS

LVMH MOET HENNESSY LOUIS VUITTON (LVMH.PA, 1M, €80.60)

Valuation

Our target price is €87. We favor a Sum of the Parts approach to valuation. In Wine & Spirits, IFRS means the group has for the first time had to publish a plausible valuation for Moet Hennessy. This value arbitrates in any potential transaction between the two owners of the JV and hence looks highly robust. Variations in the value of the three smaller divisions (Watches & Jewellery, Perfume & Cosmetics, and Selective Retail) are not material in the total. Therefore the SOTP approach essentially boils down to the valuation of Fashion & Leather and hence Louis Vuitton.

Here we assume a 10% premium value for Louis Vuitton, compared to quoted luxury peers (Hermes, Bulgari and Richemont), reflecting the highest returns in the industry and scale dominance of the sector. High volume sales at high prices allow the brand to invest in brand communication and store environment in a way no competitor can match. This gives the brand a long-run growth dynamic while offering protection for the premium returns profile, justifying our premium valuation. Our target price is based on our SOTP of €87. Our €87 price equates to a 2006E group EV/EBIT multiple of 17.1x which represents an 8% premium to its European luxury peers and also seems appropriate given LVMH's superior returns.

Risks

We rate LVMH Medium Risk. The risk rating on the stock is derived after consideration of a number of factors.

These factors include an assessment of industry specific risks, financial risk and management risk. In addition, we consider historical share price volatility, based upon the input of the Citigroup quantitative research team, as a possible indicator of future stock-specific risk. With regard to LVMH, it is important to mention limitations in disclosure, however this has improved significantly in recent years. The following risks may impede the achievement of our target price:

Changes in demand for luxury goods are correlated to the macroeconomic environment and the health of consumer spending patterns. Thus, any major change in the external political or economic scenario that may directly or indirectly affect consumer confidence is a risk to LVMH's sales results.

LVMH's businesses are highly dependent on sales to tourists. This is vulnerable to geopolitical developments such as terrorism or a flu pandemic.

The group is an exporter of products sourced in Europe and therefore can suffer adverse pressures from currency on both a translational and transactional basis. These impacts can be highly volatile and highly geared.

The group uses hedging arrangements to protect the business from the worst effects of currency pressures. However hedging gains are a one-off source of profit that can fall away rapidly.

The growth of luxury goods in emerging markets such as China, India and Russia is an important attraction for the shares. However these markets can be volatile and unpredictable.

The key profit centre in the group is Louis Vuitton. Demand for the Louis Vuitton range has grown at very positive rates. However the product is overtly branded and the group would be vulnerable to changes in consumer taste in this area.

Counterfeit goods remain a problem for Luxury Goods companies. Counterfeiting is particularly big in China and could dampen Louis Vuitton's growth prospects within this critical marketplace.

The above extracted from the report "Full Year Results First Thoughts", 2 March 2006, Analyst: Constanza Mardones

Compagnie Financiere Richemont AG (CFR.VX, 1M, SFr59.85)

Valuation

Our target price is SFr64. Richemont is defined as a luxury company and is benchmarked against a luxury peer group. However, its 18.3% share of BATs represents 36% of Richemont's enterprise value. To value Richemont we calculate a fair value for its luxury assets and rely on our BAT analyst, Adam Spielman, for the BAT target price. We acknowledge that Richemont has historically shown considerable innate volatility. A global business that reports in euros and has a Swiss franc quote, while holding a directly owned stake in another global business quoted in sterling, is to say the least unusual. There are unusually high levels of external, uncontrollable influences on the share price that are not linked to the usual luxury economics. Further, the public shares only have 50% of the voting rights, with the balance being held by companies ultimately held by the Rupert family. These issues raise legitimate concerns regarding the stock market rating. However, these issues are well known, fairly common in the luxury sector and issues of family ownership/visibility of earnings rarely become major stock market negatives in periods of P&L recovery. Despite a strong share price recovery, the Richemont luxury division still trades below sector valuation norms.

Relative valuation: We believe the last normalised (ie mid-cycle) growth and valuation cycle was 1996 to 1999. It follows that current forward luxury goods multiples should at least engage with the ratings experienced then. This is of course an imprecise exercise at the best of times, not least because accounting environments have changed, because the luxury sector in particular has/had poor earnings transparently and because the "back testing" of historical multiples references off actual profit outcomes, rather than expectations. The key influence when using such valuation frameworks has to be the confidence (or lack of) regarding current industry and sector forecast agendas. For the record, the average mid-cycle one-year forward multiple for the main luxury companies was around 23x P/E, while they are currently on a P/E multiple (on CY06 Citigroup and consensus earnings estimates) of 18.5x .

Mid-cycle (1996 to 1999) Dow Jones Euro Stoxx was trading on a TMT boom inflated year 1 P/E compared with 12.3x CY06 estimates now. The luxury goods sector traded at just over a 20% premium (23x compared with 19x) to the market in 1996 to 1999, while it is currently trading at around a 60% premium on CY05 estimates. At a sector level, one can make the case that we are yet to see "recovered peak" margins and further, that it has a unique opportunity to benefit from the current shift of the centre gravity of the global economy to Asia. Current sector earnings estimates continue to have upwards revisions whilst also offering premium earnings growth rates relative to the wider market.

Regarding Richemont, we believe the specifics of its leveraged P&L, and the probability of further upgrades make its (luxury only) P/E discount to the sector to March 2007E (10%) still look moderately conservative. The luxury only division is on 18.5x to March 2007E. We would argue that there are stronger drivers of relative earnings performance at Richemont than for the sector as a whole, not least because of the scale of the recovery seen now underway. Our target of CHF64 would see the shares on a luxury only P/E of 22.5x March 2007E, representing a 11% premium to sector averages (ex Richemont) to March 2007. This is based upon subtracting BAT's stake at our target. Equally this would put the luxury only EV to sales ratio on 3.3x, in line with sector averages. Though arguably ambitious, these multiples seem defensible on the basis that we expect further relative forecast upgrades from Richemont.

Risks

The Medium Risk rating on the stock is derived after consideration of a number of factors. These factors include an assessment of industry-specific risks, financial risk and management risk. In addition, we consider historical share price volatility, based upon the input of the Citigroup quantitative research team, as a possible indicator of future stock-

specific risk. With regard to Richemont, we would highlight the following factors that could impede achievement of our target price:

Changes in luxury goods demand is correlated to the macroeconomic environment and the health of consumer spending patterns. Thus, any major change in the external political or economic scenario that may directly or indirectly affect consumer confidence is a risk to Richemont's sales results.

After several two years of steep price increases in the US we are concerned that any return to further US dollar weakness, which would necessitate further price increases, could impact demand. We are concerned that the price elasticity could have changed.

Cartier has embarked on a strategy to increase its exposure to the entry-level luxury market. Up to a point this should be value enhancing, but Richemont needs to be watchful not to erode the brand value.

Richemont's sales are also exposed to international travel patterns. The SARS virus took a toll on traveller numbers, but bird flu is now a risk, albeit one that is very hard to quantify. Terrorism attacks could severely impede travel and hence Richemont's growth.

Company management is faced with the task of sustaining the more costconscious, business-case driven strategy, which will require different skills from the old "maison" driven strategy.

Industry overcapacity and shorter development cycles could see a plethora of new launches from Richemont and its competitors that could push up costs.

Though we believe Richemont still offers good prospects of upwards earnings revisions we wonder if the second half of this year will represent the tail end of the supernormal growth phase. Further, though it is impossible to quantify the odds, there is no denying that Richemont has shown above-average revenue vulnerability to events that have disrupted travel patterns. Avian flu could be highly disruptive of travel patterns.

Exposure to the tobacco industry is a more company-specific risk. Richemont's investment in BAT gives it exposure to the tobacco industry, and the share price is thus susceptible to the litigation that goes with tobacco.

The above extracted from "Richemont: What a Wonderful World", 30 January, 2006, Analyst: Bruce Hubbard

ANALYST CERTIFICATION — APPENDIX A-1

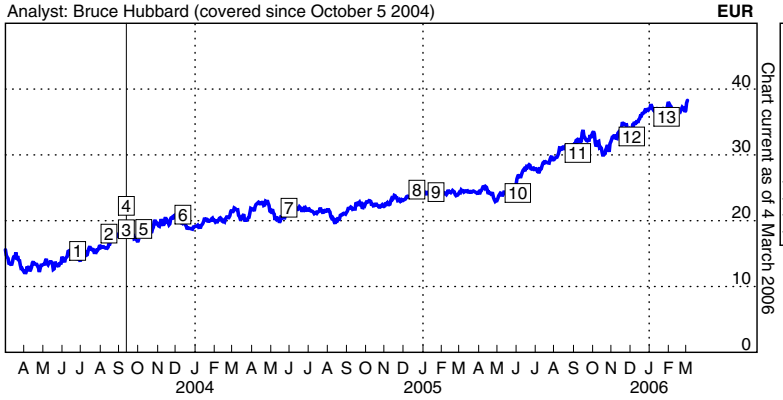
We, Ajay Kapur, Niall MacLeod and Narendra Singh, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Richemont (CFR.VX)

Ratings and Target Price History - Fundamental Research

Analyst: Bruce Hubbard (covered since October 5 2004)


EUR
40
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A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M
2004
2005
2006
Chart current as of 4 March 2006
Covered
Not covered

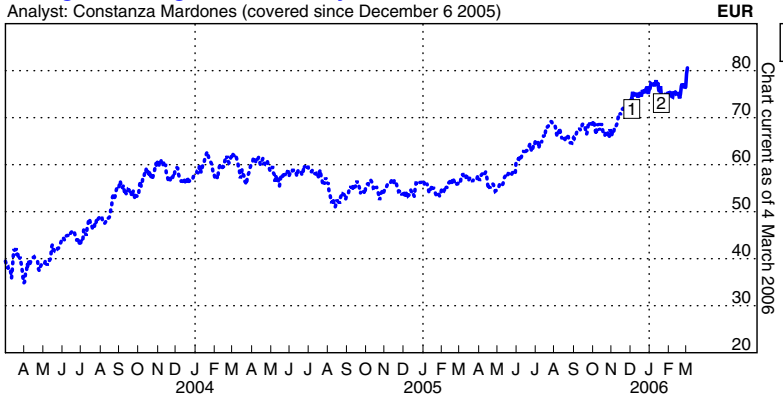
#	Date	Rating	Target Price	Closing Price
1:	26 Jun 03	3H	*14.97	14.22
2:	15 Aug 03	*2H	*16.39	16.49
3:	12 Sep 03	Stock rating system changed		
4:	12 Sep 03	*2H	*16.93	18.50
5:	10 Oct 03	2H	*18.37	17.99
6:	12 Dec 03	*3H	*19.18	19.57
7:	1 Jun 04	*1H	*25.59	20.85
8:	23 Dec 04	*1M	*31.40	24.61
9:	24 Jan 05	1M	*29.90	23.71
10:	3 Jun 05	1M	*28.53	26.75
11:	8 Sep 05	1M	*36.60	31.99
12:	5 Dec 05	1M	*37.21	33.77
13:	30 Jan 06	1M	*41.19	36.75

*Indicates change.

LVMH (LVMH.PA)

Ratings and Target Price History - Fundamental Research

Analyst: Constanza Mardones (covered since December 6 2005)



#	Date	Rating	Target Price	Closing Price
1:	5 Dec 05	*1M	*81.68	73.95
2:	20 Jan 06	1M	*87.00	74.75

*Indicates change.

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Citigroup Investment Research Ratings Distribution

Data current as of 31 December 2005	**Buy**	**Hold**	**Sell**
Citigroup Investment Research Global Fundamental Coverage (2784)	42%	41%	17%
% of companies in each rating category that are investment banking clients	47%	48%	37%
Luxury Goods -- Europe (6)	100%	0%	0%
% of companies in each rating category that are investment banking clients	17%	0%	0%

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